Shadow Banking and Financial Instability: Lord Turner speech to the CASS Business School

FSA/PN/027/2012
14 Mar 2012

In a speech to the CASS Business School the Chairman of the Financial Services Authority (FSA), Lord Turner, set out how the 'shadow banking' sector contributed to the financial crisis, the risks it still poses to financial stability and the importance of a sufficiently comprehensive and radical policy response.

He highlighted that the 2007-08 financial crisis was not one simply caused by high street banks but one where shadow banking activities played a major role. He described how the shadow banking sector is not simply a standalone system running parallel to the regular banking system but is linked to the banking system in complex and difficult to discern ways that can make the whole system less stable.

He stressed that major reforms had been put in place in the wake of the crisis for 'normal' banks including increased capital and liquidity requirements and better supervision, but said there had yet to be a similar response to the 'shadow' sector and that this needed to be addressed urgently.

He said:

"In autumn 2008 the developed world's banking system suffered a severe crisis. And since then the world's regulators and central banks have focused on building a more stable banking system for the future: less leverage, more liquid, better supervised and with even the largest banks able to be resolved without taxpayer's support.

"But it's striking that the crisis did not initially seem to be one of banks themselves, but rather of an apparently new phenomenon: shadow banking. So we need to ensure that our regulatory response appropriately covers shadow banking as well as banks."

Lord Turner described shadow banking as covering multiple specific institutions and activities including securitised lending, hedge funds active in credit markets, investment bank trading of credit securities, the issuance of asset backed commercial paper and the 'repo' market. He set out how money could move through the system in long and complex chains which in combination performed the same role as banks, which involved the same risks, but which fell outside the framework of controls with which regulators seek to make the banking system safe. Estimates of the size of the shadow banking system were, Lord Turner stressed, very uncertain because of the sheer complexity of the system, but some researchers have suggested figures of around $20tn for shadow banking activity in the US in 2007 and around $13tn in Europe.

He argued that some of the particular forms which shadow banking took in the pre-crisis period had declined in importance, but that the underlying factors which drove shadow financial system can safely provide;

2. The tendency of financial innovation continuously to create additional complexity and opacity, and to make the system more interconnected and vulnerable to shocks; and
3. The increasing role of short term secured financed – such as the repo markets, which when combined with mark-to-market accounting and continuous revaluation could "hardwire" potential instability into the financial system.

Lord Turner said:

"We need to understand shadow banking not as something parallel to but separate from the core banking system, but deeply intertwined with it.
"The way in which shadow banking contributed to financial instability reflected and still reflects fundamental developments in our financial system which are relevant to banks as much as to shadow banks, which remain important today and which could produce new problems in the future.

"We should not take the decline in some specific indicators of shadow activity which has occurred since 2008 as suggesting that the risks have gone away."

He reaffirmed the determination of the Financial Stability Board (FSB) to get to grips with shadow banking issues, ensuring that adequate responses to the risks involved were put in place. He stressed that any response would need to be flexible because in a complex financial system, individual firms will continually innovate new products and new relationships between firms which reduce the risks to the individual firms but which can make the system as a whole more risky.

He noted that some of the risk had been apparent in the earlier 1998 failure of the huge hedge fund Long Term Capital Management, that some of the reforms now being discussed had been considered in its aftermath, but that the action had not been taken once the crisis receded. He added "This time around we need to ensure that we maintain the momentum of reform, and that our response is sufficiently radical".

Notes for editors

1. Lord Turner's speech is available on the FSA website.
2. Lord Turner is Chairman of the international Financial Stability Board's (FSB) Standing Committee on Supervisory and Regulatory Cooperation, which is responsible for the development of the FSB's regulatory reform proposals for the shadow banking system. His speech contains a description for the work programme which will deliver these proposals.
3. The FSB issued in October 2011 a description and broad explanation of shadow banking.
4. The FSA regulates the financial services industry and has four objectives under the Financial Services and Markets Act 2000: maintaining market confidence; securing the appropriate degree of protection for consumers; fighting financial crime; and contributing to the protection and enhancement of the stability of the UK financial system.

More **Press Releases**:

2012 2011 2010 2009 2008 2007 2006 2005 2004 2003 2002
2001 2000 1999